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Anatomy of a Micro-finance Deal: The New Approach to Investing in Micro-finance Institutions

What is the best way to support a micro-finance institution (MFI) that has a track record of extending quality financial services to significant numbers of poor people on a progressively financially sustainable basis? The CGAP Secretariat has begun to examine this question through the application of a new model for cooperation between international donors and MFIs. The new approach focuses on a business-like relationship based on mutual accountability, institutional performance, and shared risks. This note critiques the more traditional "project-oriented" strategy and then outlines the basic elements of the new institutional approach with some examples from the CGAP Secretariat's experience.

Traditional Micro-finance Projects

Traditionally, many donors have viewed micro-finance NGOs or other institutions as channelers of their resources to particular target groups. Each donor typically specifies the target group as having particular characteristics related to gender, geographical location, poverty level, or economic activity. Each donor usually requires specific reporting and often separate audits related to its funding, as opposed to reporting that speaks to the overall institutional performance of the MFI, in terms of increased outreach to the poor and progression towards financial sustainability.

Not surprisingly, those MFIs successful at attracting donor funding find themselves juggling the special interests and varied reporting requirements of several donors at once. In addition, donors may place restrictions on interest rates or terms on their funds and tie technical assistance or equipment to their own suppliers. The funds are often restricted to specific categories and purposes which may not coincide with the MFI's need for funds, for example, donor funds are given to cover operating costs when the MFI needs loan funds, or vice versa. This targeted, project-oriented approach often makes it difficult for institutions to reach financial viability in the most efficient way. At best, the focus on an individual donor's project view complicates operations, increases administrative costs, and deviates the MFI's attention from managing the operations as an enterprise as opposed to an amalgamated patchwork of special funds. At worst, this approach engenders excessive dependence on foreign funds and technical inputs and deviations from an MFI's original objectives.

Other problems with the traditional approach relate to the donors' disbursement imperative. Donors often pressure MFIs to disburse their funds at a rate that may not be appropriate for the MFIs' internal development and liquidity requirements. On the other hand, the donors' own disbursement requirements often mean that conditionality is rarely binding, with the MFI facing little or no consequences for non-compliance or poor performance.

MFIs often complain about the mismatch between the targeted purpose of funds and their institutional requirements on the one hand, and the

unpredictability of the timing of disbursement on the other. In many cases, the process for obtaining funds is slow and inflexible and lacks transparency.

Principles of the New Institutional Approach

To avoid the pitfalls inherent in the targeted project approach, the CGAP Secretariat, in consultation with its Member Donors and Policy Advisory Group, has applied a new **institutional** approach to support MFIs with proven track-records and a high potential for massive outreach and financial viability. This new approach is based on a business-like partnership that clearly defines roles and responsibilities for both the donor and the MFI partner. The premise behind the new partnership is that the donor sees itself as an "investor," with institutional performance substituting for dividends as a "return" on that investment.

The process for launching a partnership under the new approach entails a transparent application process and clear focal point for accessing funds, an in-depth institutional appraisal, the development of the MFI's medium-term business plan, the formalization of the deal through a Partnership Agreement, and the establishment and periodic monitoring of institutional targets. While there exists a certain amount of flexibility within each step, a few basic principles remain constant. The overall process is described below.

1. The Focal Point: Where and How to Start

Many MFIs experience problems in identifying the appropriate focal point within a donor agency to begin the process of accessing funds. Donors often have multiple instruments (grants, loan financing, loans to government entities) administered by decentralized agencies, whose funding criteria are not always transparent. The CGAP Secretariat has tried to address this problem by creating a single focal point that all MFIs can access through a standard, widely available application form with clearly defined funding criteria.

2. Institutional Appraisal: The Up-Front Investment

When a particular MFI looks promising, the Secretariat undertakes a comprehensive institutional appraisal in the field. This appraisal differs substantially from traditional donor appraisals. The latter tend to address the question "How can this MFI fit into our project?" The institutional appraisal asks "What is this MFI's track record in reaching increasing numbers of poor people efficiently and how consistent is its vision for growth in the future with its past performance?" Answering this question is the cornerstone of an investment process, because it enables both parties (the donor and the MFI) to make an informed decision regarding investment priorities.

Understanding the MFI's scale of outreach and the relative poverty of the clientele, the quality of the financial services and of the loan portfolio, governance, management capacity, vision and plans for the future, financial performance over time, and the existence or potential for sound information systems constitute important elements of the appraisal. Gathering this information is a joint effort of the MFI and the appraisal analyst(s). The team uses a document called *the Appraisal Format*¹ that covers a wide array of institutional, financial, and operational issues to guide the assessment. The appraisal process can become a form of technical assistance to the MFI and a form of institutional self-diagnosis. For instance, over the course of the appraisal of Compartamos, a Mexican MFI, the institution's portfolio tracking and accounting systems were identified as inadequate for the MFI's current and future needs. The appraisal team provided critical input into the subsequent design of the institution's information systems. Nearly all the MFIs appraised to date by the Secretariat have stated that the appraisals themselves were useful exercises for their future institutional development even if

funding was not forthcoming.

The completion of an appraisal in and of itself does not guarantee funding for the MFI. In the case of the CGAP Secretariat, ten of the 17 MFIs appraised as of June 1997 have received funding, three will likely receive funding in the future, and four were deemed incompatible with CGAP objectives.

3. **The Business Plan: Implementing the Vision**

Once the appraisal provides a clear picture of the institution's past performance and its management's vision for the future, the next step is for the MFI to prepare a institutional business plan. The business plan consists of reasonable projections over a three to five year period with regard to the number of clients, portfolio balances, and other financial statement information. These projections should be based on sound assumptions reflecting past experience and future potential in the number of branches and loan officers, their operational capacity, likely products and customer behavior, financial flows, etc. The completed business plan determines the contours of the investment, including the amount, timing, and institutional targets. Several CGAP Secretariat MFI partners such as SHARE in India, ACEP in Senegal, and Women's World Banking affiliates in Latin America completed their business plans during or shortly following the appraisal.

On the other hand, many otherwise promising MFIs have weak financial planning capacities and require some help in developing their business plans. The Secretariat has provided support to selected MFIs in developing their business plans. Two different approaches to this kind of support are discussed in Box 1.

Box 1:

In-kind technical assistance: ACODEP, an NGO operating in Nicaragua, had relatively advanced knowledge and interest in business planning, but needed some help with the technical aspects of financial projections. As an initial step, the Finance Manager of Compartamos, an early CGAP partner, assisted ACODEP in developing its plan and financial projections -- all at ACODEP's request and expense. This step was followed up by a comprehensive business planning/financial projections workshop facilitated by Secretariat staff.

Funding: Rural Finance Facility (RFF) of South Africa and Zambuko Trust of Zimbabwe required resources and expertise to help them develop their business plan. CGAP signed a Partnership Agreement with each of the two MFIs to fund the hiring of the necessary expertise to create a comprehensive business plan supported by financial projections. This approach has the advantage of allowing RFF and Zambuko the freedom to contract whatever specialized support they deem necessary.

4. **The Partnership Agreement: Formalizing the Deal**

The Partnership Agreement between CGAP and the MFI defines the rules of the game for the future relationship. It describes fully the rights and responsibilities of the parties involved, the reporting requirements, and the institutional targets against which the MFI will be monitored.

The terms and conditions of disbursement constitute perhaps the most important aspect of the Partnership Agreement. They do not place the MFI under pressure to spend the funds within a tight time-frame. Conversely, if the MFI is in need of funds earlier than the planned disbursement date, it can receive these funds subject to continued institutional performance and a full justification of the use

of the previous tranche. In most deals, the initial disbursement occurs upon signing the Agreement, with future disbursements contingent on meeting the agreed targets. The MFI is free to utilize the funds for any valid purpose of its own choosing, and is monitored against its institutional performance targets.

In case of failure to meet the institutional targets, CGAP reserves the right to terminate future disbursements. Just as a commercial investor will seek alternative opportunities should current investments fail to yield acceptable returns, CGAP intends to discontinue investing scarce resources in institutions that fail to meet performance expectations.

5. **Institutional Targets and Reporting Requirements: Taking Responsibility for Performance**

The institutional targets in the Partnership Agreement are not synonymous with the financial projections contained in the business plan, although they are related. Financial projections often represent more "hopeful" (although achievable) goals toward which management plans to strive; institutional targets (usually lower) are concrete minimum targets that management is **committed to meet**, giving the MFI some latitude should something go wrong.

The indicators that are monitored as targets arise from the results of the institutional appraisal and the goals set out in the business plan. This process for setting targets reflects the concerns and vision of the MFI's management. Perhaps most important is the fact that no separate reporting is required for monitoring the targeted indicators. They can be derived from the MFI's financial statements and other reports that are already produced for management purposes.

Target indicators commonly relate to client outreach, portfolio quality, growth, and profitability, and rarely exceed five in number. However, they can differ and are tailored to the level of the MFI's development and the issues confronting it (See Box 2). Specific target levels for each indicator over a period of three to five years are determined through negotiations between the MFI and the CGAP Secretariat. These targets are commonly set quarterly, although reporting on progress can occur less frequently.

Box 2:

SHARE, a Grameen Bank Replicator in India, plans to more than double its outreach to 11,000 poor clients and become financially sustainable by the year 2001. To do so, it will expand the number of existing branch offices and invest in building staff skills and strengthening existing information systems. The six monthly performance targets in the Partnership Agreement between CGAP and SHARE include: progress in expanding client outreach, maintaining high portfolio quality, lowering operating costs, and turning a profit by 2001.

Centenary Rural Development Bank in Uganda is a full-fledged commercial bank servicing poor clients. During the CGAP appraisal, the Secretariat noted concerns on the potential for Centenary to drift from providing loans to the poor toward wealthier clients. To ensure that it continues to serve poor clients, the Partnership Agreement with Centenary includes small initial loan sizes as an institutional target. Other indicators in this Agreement relate to Centenary's financial health such as capital adequacy standards and delinquency rates.

6. **Monitoring: Maintaining Accountability**

The institutional approach relies largely on the MFI to track its performance relative to the established targets. For this reason, it is

crucial that both parties are "speaking the same language" with respect to calculating the performance indicators from the MFI's existing or projected financial statements and/or operations MIS. The Secretariat conducts periodic visits to MFI partners, less to monitor their performance in the traditional sense than to strengthen what is seen as a strong relationship between the two parties. The visits seek to develop a long-term relationship with the MFI partners and to serve as an opportunity to continue supporting them in reaching their institutional objectives. To date, CGAP's MFI partners have comfortably met their institutional targets.

Replicability of the New Institutional Approach

The CGAP Secretariat has benefited from a number of structural advantages in its application of the new institutional approach. First, its funding instrument - direct funding to MFIs - is particularly conducive to accountability between the Secretariat and the MFI partner. Second, the administrative mechanisms and procedures are flexible, transparent, and responsive to the MFI's needs, allowing the Secretariat to process investments relatively quickly, thus helping ensure that the investment remains relevant to the MFI's requirements. Finally, the Secretariat has gradually built a team of technicians and has tapped into quality external resource persons to work through every step of the partnership process.

All donors may or may not enjoy these advantages. However, a number of the core principles embedded in the new institutional approach to supporting MFIs can be more easily integrated into many donors' programs. These principles include clearer and more transparent procedures, **institutional** appraisals as opposed to **project**-level appraisals, and funding based on institutional performance rather than targeted funding. As the role of donors in the micro-finance industry continues to evolve over the next few years, it is hoped that adoption of all or part of the new institutional approach will leave a legacy of a healthy and sustainable micro-finance industry providing quality financial services to millions of poor people throughout the world.

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¹The appraisal format is available upon request from the CGAP Secretariat. If you would like a copy, please send your request via e-mail to: cproject@worldbank.org. The request should include a contact name and a complete mailing address.